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JAMES H. McKENNEY,
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No. 150.

Mr. of Follansbee, Robbins & Co.

for Petitioners.

IN THE

Supreme Court of the United States.

OCTOBER TERM, A. D. 1900.

Filed Jan. 7, 1901.

No. 150.

UNITED STATES RUBBER COMPANY et al., *Petitioners,*
vs.
AMERICAN OAK LEATHER COMPANY et al., *Respondents.*

Certiorari to the Circuit Court of Appeals for the Seventh Circuit.

Brief and Argument of Henry S. Robbins for Petitioners.

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STATEMENT.

There are two questions in this case:

1. Whether certain preferences given by an Illinois trading corporation to the petitioners, three of its creditors, are fraudulent, and,

2. If so, whether by taking and relying upon such preferences these creditors lost their right to share *pro rata* with the other creditors in the insolvent estate.

For a number of years prior to January 6 1896, C. H. Fargo & Co., a corporation, had conducted in Chicago a large business (from $1,250,000 to $1,400,000 per annum) as a manufacturer and wholesale dealer in boots and

shoes, having in 1892 succeeded a firm of that name. This corporation was essentially a family affair, all its stock being owned by three brothers, Charles, Frank and Edward Fargo. Prior to January 9 1896, these brothers constituted all its officers, Charles being president, Frank vice-president and treasurer and Edward secretary. They together with four employes of the company, who owned no stock and took no part in the management of its business (Rec., p. 159), constituted its board of directors.

On the 6th day of August, 1896 Fargo & Co. failed, and this resulted in the following preferences:

Two judgments by confession August 6 1896 in the Federal court in Chicago against Fargo & Co., one in favor of the United States Rubber Company for $145,400 upon a judgment note payable on demand for $140,000, and dated January 6 1896, and one in favor of L. Candee & Co. for $38,300 upon a judgment note of the same date due on demand for $51,500.

An assignment August 6 1896 by Fargo & Co. to the United States Rubber Company of all its book accounts as collateral security for its indebtedness to said two rubber companies pursuant to an agreement to so assign made January 6 1896.

A judgment by confession in the state court at Chicago August 6 1896 against Fargo & Co. in favor of the Metropolitan National Bank for $25,250 upon a judgment note dated August 5 1896 and made by Fargo & Co. payable to said bank for $25,000.

Two warranty deeds from Fargo & Co. to said bank dated August 6 1896 conveying its factory at Dixon Illinois.

Upon the judgments in favor of the petitioners United States Rubber Company and L. Candee & Co. (hereafter called the Rubber Companies), executions were immediately issued and levied upon all the tangible assets of Fargo & Co., and on the same day, but subject to the foregoing levy, a similar levy was made under the Metropolitan Bank judgment; whereupon on the 11th of September 1896 the American Oak Leather Company, after having obtained a judgment against Fargo & Co. and the return of an execution thereon *nulla bona*, filed the present bill against Fargo & Co., these petitioners and the marshal attacking the foregoing preferences as illegal because made with intent to defraud, hinder and delay the other creditors of Fargo & Co., and praying that the same be set aside and its assets applied to the payment of its *bona fide* creditors.

Subsequently other creditors, whose claims aggregate about $150,000, joined complainant in the suit.

After answers were filed fully disclosing the real facts the court issued a mandatory injunction without bond and placed the assets in the hands of a receiver (Rec., p. 79), and upon appeal this order was affirmed—82 Fed., 248.

Thereafter, the case being at issue, the Circuit Court on motion of complainant referred it to Henry W. Bishop, Esq. master in chancery "to take proofs herein and report the same, together with his conclusions thereon, as to the facts only" (Rec., p. 156), and after a protracted hearing the master made his report finding the facts to be substantially as set forth in the answers of these petitioners. That report, so far as relevant to this hearing, is as follows, the italics being ours (Rec., pp. 160–171):

"There was due January 6, 1896, to Candee & Co.

upon the notes of C. H. Fargo & Co. (given in settlement in November, 1895), the sum of $44,900, and on the same date there was due from the Fargo Company to the United States Rubber Company on open account for proceeds of sale of consigned goods the sum of $141,537.13.

It is shown by the testimony, and I so find, that about January 2, 1896, the C. H. Fargo Co., anticipating difficulty in meeting its regular obligations maturing during that month, applied to one Charles L. Johnson, who represented both the Candee Company and the United States Rubber Company, for a loan of $50,000, representing that the Fargo Company was perfectly solvent and that this accommodation would relieve it from its temporary embarrassments, and enable it to go on with its business.

This application was granted, and on January 6, 1896, Johnson agreed, acting for L. Candee Company, to lend the Fargo Company the sum of $50,000 for six months upon the understanding that this loan and the indebtedness of $44,900 upon the notes previously given as aforesaid and the balance due the United States Rubber Company, and which might become due it, should be secured in such a way as might be satisfactory to their counsel, Mr. Beale, of the law firm of Isham, Lincoln & Beale.

The proposition was accepted on the 6th day of January, 1896, and it was agreed and arranged between the parties as follows:

First. That the $50,000 should be advanced to the Fargo Company by L. Candee & Co., partly on that date and during the succeeding two weeks.

Second. That the Fargo Company should that day execute and deliver its three judgment notes, one for $45,000 payable on demand to the order of L. Candee & Co., to secure that company with respect to its liability as endorser or guarantor upon the notes for $44,900 given previous to January, 1896, one for $51,500 payable on demand to L. Candee & Co., as collateral security to plain notes of the Fargo Company, which were given as evidence of the advance of $50,000 then to be made, and one for $140,000 payable on demand to the order of the United States Rubber Company, as collateral security to

the then existing and to any future indebtedness of the Fargo Company to the United States Rubber Company as aforesaid.

Third. That in case the Fargo Company should at any time find it necessary to suspend business, it would assign as additional security all its accounts and bills receivable; that it should not give any judgment notes to other creditors which would impair the security to the Rubber Companies, *and that the $50,000 advance should be used by the Fargo Company in reduction of its general indebtedness as it matured;* and

Fourth. That the four employes of the Fargo Company who were on the board of directors, and also E. A. Fargo, should retire from the board and there should be elected in their places by the stockholders of the company five persons, to be nominated by said Beale, in whom he had confidence, one of whom should become secretary and treasurer, *and that the directors so to be elected at Beale's nomination should not hamper or interfere with the proper carrying on of the ordinary business of the company.*

* * * * *

I find that the attention of the general creditors was never called to this arrangement and they had no knowledge of it. The Metropolitan National Bank first learned of it at or about the time a judgment note was given it to secure the payment of its claim of $50,000 as hereinafter stated.

I find that in pursuance of this arrangement, and on January 6, 1896, a meeting of the board of directors of the C. H. Fargo & Co. was had before any change in said board, when a resolution was passed authorizing the borrowing of the $50,000, the giving of judgment notes, as in said agreement provided for, and assignment of the accounts, bills and choses in action upon the contingencies agreed upon; and upon the same day the three judgment notes referred to were executed and delivered by Charles E. Fargo, president of the company; Frank M. Fargo, vice-president and treasurer, and E. A. Fargo, secretary, and the loan of $50,000 was perfected, $10,000 being advanced at the time and the balance of $50,000 during the succeeding two weeks.

This action was ratified on the 8th day of January,

1896, by the unanimous vote of the stockholders of C. H. Fargo & Co., all the shares being represented.

I find that in pursuance also of said arrangement, and as a part of it, at a meeting of the stockholders of C. H. Fargo & Co., held January 9, 1896, George C. Madison, Tiffany Blake, Buell McKeever, Frederick B. Fuller, Gilbert E. Porter, Charles E. Fargo and F. M. Fargo were duly elected directors for the ensuing year.

The first five, except Blake, were employes in the office of William G. Beale, and said Blake was assistant corporation counsel of the City of Chicago, of which William G. Beale was then corporation counsel, and all five were elected by the stockholders at the suggestion of said Beale. Subsequently, at a meeting of the newly constituted board, at which Charles E. Fargo was re-elected president of the company, Frank M. Fargo was re-elected vice-president of the company and Buell McKeever was elected secretary and treasurer of the company, the by-laws of the company were amended providing against the giving of judgment notes or preferential security without special authorization of the board of directors.

I also find that the change of the board of directors and officers, and the changes of the by-laws of said company and the resolution thereof authorizing judgment notes and assignments of accounts if necessary, were all for the purpose of giving preferential security to the Rubber Companies, and the matter was kept secret in order to allow the Fargo Company an opportunity of getting through embarrassments apparently temporary but not with a fraudulent intent as to the other creditors of the company. The only purpose and object of changing the board of directors as aforesaid and of amending the by-laws was to protect the Rubber Companies against the giving by the Fargo Company of preferential security or judgment notes to other of its creditors which should be superior to the security of the Rubber Companies.

I further find that the arrangement as made was carried out in good faith by the parties and that the directors elected at the suggestion of said Beale took no part in the active management of the Fargo Company after their election, and that no stockholders' or directors' meetings

of the Fargo Company were held after January 9, 1896, until August 5, 1896.

I find that on January 9, 1896, which was the date of the meeting of the new directors, the authorized capital stock of the said corporation of C. H. Fargo & Co. was $400,000 and the debts of the corporation on January 6, 1896, as follows:

Amount owing United States Rubber Company	$141,537 13
Amount owing Candee & Company	44,900 00
Amount owing Metropolitan National Bank	50,000 00
Amount owing other creditors	210,216 20
Total	$446,653 33

I find that the value of the assets of C. H. Fargo & Co. at that time had not been definitely ascertained, but I find, as a matter of fact, as the results of efforts since made in collecting the same in liquidation and from other sources of information disclosed by the testimony, that on the 6th day of January, 1896, the assets of said company were not sufficient to discharge its indebtedness, *of which fact the defendants, the Rubber Companies, are shown to have been ignorant, relying upon the representation of the Fargos that there was a large excess of assets over liabilities.* The fact that Johnson, representing the Rubber Companies, made no detailed examination of the assets of the company, but consented to advance the money which was applied for, is evidence to my mind that he believed in the assurances which were given him by the Fargos of the condition of their company.

I further find that between January 6, 1896, and August 6, 1896, the new liabilities incurred by said corporation to creditors other than the Rubber Companies and the bank were $246,660.54 (of which there was due and unpaid on August 6, 1896, $142,690.95), and that during the same period the Fargo Company paid out more than $300,000 to its general creditors in the regular course of business, paying substantially all of the indebtedness of January 6, 1896, which was largely to the same persons who are now creditors.

I further find that between January 6 and August 6, 1896, the Fargo Company continued its business as be-

fore, *reducing its general indebtedness to a considerable extent with its general creditors;* that during said time it paid Candee & Co. $44,900, the amount of its indebtedness prior to January 6, 1896, and $13,470 on account of the advance of $50,000 as aforesaid; that during said time it paid to the United States Rubber Company $15,000 on account of the indebtedness to that company existing January 6, but it also sold consigned goods of that company to the amount of $24,534.04, of which it remitted only $5,495.40; and that on August 6, 1896, there was due to the United States Rubber Company the sum of $142,424.81, and to L. Candee & Company the sum of $36,530.

I further find from the testimony that the indebtedness of the Fargo Company, which was incurred after January 9, 1896, up to the time of the entry of judgment upon the judgment notes referred to, was incurred in ignorance of the giving of the judgment notes and the change of directors, and of the change of officers, and of the arrangement existing between the Rubber Companies and the Fargo Company, and that the amount of the claims that were thus contracted and is still unpaid exceeded $110,000.

I find that while Johnson and Sadler, representing the Rubber Companies, were here from January 2 to January 6, 1896, that it was then agreed that separate books showing sales of consigned goods should be kept, and the proceeds of the sales thereof should be kept in a separate bank account, which was done.

I find that the advance of $50,000 on January 6, 1896, and the giving of the judgment notes and security referred to, was the result of an evident feeling upon the part of all the parties to the transaction, and was in the belief and expectation on their part, that through the assistance which was in this way afforded the Fargo Company it would be enabled to continue its business successfully and become ultimately relieved of its financial embarrassment, and that said arrangement was entered into in good faith and without any fraudulent intent.

I find that the testimony does not show that the parties were influenced in making the arrangement aforesaid upon a belief of the insolvency of the Fargo Company at

that time, and the conduct of the corporation afterwards and until about the time of the entering up of the judgment notes, in my judgment, clearly indicated the hope and expectation that the Fargo Company would be finally relieved of its troubles.

In support of this conclusion I find that in the meantime and between January 6, 1896, and August, 1896, in the regular course of its business the Fargo Company reduced, to a large extent, the indebtedness which existed on January 1, 1896, increasing the capacity of their manufacturing business, reducing its stock and discharging, to a large extent, its general liabilities, except with the United States Rubber Company and the Metropolitan Bank, with an evident purpose and expectation of continuing its business; during which time nothing is shown to have occurred with these parties inconsistent with this theory.

I find that during this period the general creditors were substantially the same as before, with the exception of the Eagle Tanning Works of Chicago, whose claim of $2,500.24 has been established, for the goods purchased on credit between April 1, 1896, and July 15, 1896, and Wilder & Company, and the Pfister & Vogel Leather Company, hereinafter mentioned.

* * * * *

And I also find that during this time upon the letterheads of the C. H. Fargo Company the printed names of the Fargos, treasurer and secretary, appeared as before, without anything to show any change in the construction or management of said corporation, nor were such changes in any way mentioned, or their real condition disclosed.

* * * * *

I further find that during many years prior to January 6, 1896, the C. H. Fargo Company had been doing business with the Metropolitan National Bank of this city, its banker, resulting in the creation from time to time of a large indebtedness to said bank, which was finally reduced, in the usual course of business, so that on the 5th day of August, 1896, said indebtedness amounted to the sum of $40,000.

That the Metropolitan National Bank, during the sum-

mer of 1896, applied to C. H. Fargo & Co. to reduce its indebtedness to it and to finally discharge it by the month of November following.

I further find that at the same time said bank gave the C. H. Fargo Company said notice, and down to about the 3d or 4th day of August, A. D. 1896, it had no knowledge of any transactions which occurred between it and the Rubber Companies in the previous month of January, and that it did not know of the change in the board of directors of said C. H. Fargo & Co., or that it had given the Rubber Companies judgment notes for an indebtedness owing by it to said Rubber Companies, or of the agreement which had been entered into in respect to the same between it and the Rubber Companies, or of the action which had been taken by the newly-constituted board in pursuance of this agreement.

I further find that on or about Monday, the 3d day of August, A. D. 1896, Charles E. Fargo, president of the said C. H. Fargo & Co., called at the Metropolitan National Bank, and while there applied to the bank for an additional loan of $10,000.

I find that during this interview, or shortly thereafter, the said Charles E. Fargo informed the president of said bank that the said C. H. Fargo & Co. had given the Rubber Companies judgment notes for the amount of its indebtedness to them, and that while said C. E. Fargo insisted that the assets of his company were at that time largely in excess of its indebtedness and ample to meet the entire amount thereof, that, owing to the difficulty in making its collections as rapidly as its outstanding paper matured, his company would be obliged to fail unless it received some assistance.

I find that at the time of said interviews the said C. E. Fargo represented to the president of said bank that the said C. H. Fargo & Co. was indebted to him and his brothers for money exceeding $10,000 which they had borrowed upon their notes for the benefit of the company, and which they had paid over to the company for use in its business, and that said Fargo brothers had put up some bank stock that they owned as collateral to said notes, and C. E. Fargo thereupon proposed to said bank that if it would loan said C. H. Fargo & Co. $10,000 in

addition to its then existing loan, so that said company could reimburse him and his brothers and enable them to take up said notes, he would procure from the said C. H. Fargo & Co. judgment notes for said bank, both for said sum so advanced as aforesaid, and also for notes then remaining due said bank to the amount of $40,000.

I further find that said bank acceded to said proposition, and loaned said C. H. Fargo & Co. said additional sum of $10,000, receiving two judgment notes of the Fargo Company for the sum of $25,000 each, crediting to the account of said C. H. Fargo & Co. in said bank said sum of $10,000.

I further find that at the time of the completion of this arrangement with said bank, neither the bank nor its officers nor attorneys had any knowledge of the change of the board of directors of the said C. H. Fargo & Co., or of its by-laws, but the bank did know that the Rubber Companies, as a part of the final arrangements made, were entitled equally with themselves to enter judgment upon the judgment notes which had been given.

I further find that neither the complainants herein nor any of the other creditors of the said C. H. Fargo & Co. were led to give credit to said company by reason of the transactions had between it and the bank, nor did any of said parties sell any goods to said C. H. Fargo & Co. subsequent to the time when said bank made said $10,000 loan aforesaid to C. H. Fargo & Co., nor did the said bank in any way participate in or have any knowledge of the change in the by-laws of said C. H. Fargo & Co. as aforesaid.

I further find that from about the time when the said judgment notes were given to said bank, as aforesaid, the said bank entered into a stipulation with the Rubber Companies by which it was agreed that they should unite their efforts to collect their respective claims against the said C. H. Fargo & Co. and should share *pro rata* in whatever proceeds should be derived therefrom.

* * * * *

I further find upon the testimony submitted to and taken before me in connection with this branch of the

case, that the defendant, the Metropolitan National Bank, is not shown to have been guilty of any actual fraud as against the complainants or the other creditors of C. H. Fargo & Co. by reason of any of its transactions with the said defendants, C. H. Fargo & Co. or the said Rubber Companies.

I further find that August 6, 1896, before entry of the judgments in favor of the Rubber Companies as set forth in the pleadings, C. H. Fargo & Co., by its president, C. E. Fargo, duly assigned to the United States Rubber Company all the accounts and bills receivable of the Fargo Company as further security for the indebtedness to the Rubber Companies, pursuant to and in accordance with the agreement made in January, 1896.

I find nothing in the testimony which has been taken before me upon this reference which so changes the record which was before the court upon the hearing of the application for the appointment of a receiver as to lead me to a conclusion different from that announced by the court at that time; *indeed, the effect of the testimony, in my judgment, is to explain and strengthen the conclusion then expressed by the court, that there was no fraud in fact or want of good faith shown in the conduct of any of the defendants in respect to the transactions complained of; and upon a careful examination of the whole record and testimony I so find and report.*"

Sundry exceptions filed by respondents (Rec., pp. 604–636) were overruled by the Circuit Court, and the report was in all respects confirmed, but a decree was entered setting aside the above preferences to petitioners as "fraudulent in law (although not at the time believed by the parties to be such, but, on the contrary, believed to have been within their rights) as against the other creditors of C. H. Fargo & Co.," and directing its assets (about $111,000) in the hands of the receiver to be distributed *pro rata* among its creditors, including petitioners. (Rec., p. 639.)

The case was taken by appeal and cross-appeal to the

Circuit Court of Appeals, which by a divided court reversed the decree in so far as it permitted petitioners to share *pari passu* in the fund to be distributed, thus in effect depriving petitioners of any share in the distribution.

Mr. Justice Brown, however, filed a dissenting opinion favoring affirmance.

Thereupon this court, upon the petition of the Rubber Companies and the Metropolitan Bank and the cross-petition of the complaining creditors, issued the present writs of *certiorari*.

Specifications of Error.

The errors and cross-errors assigned upon the record (Rec., p. 645, 646, 667-692) present the two questions stated at the outset, and petitioners claim that the decree of the Circuit Court was erroneous in not dismissing the bill for want of equity, and that if this be not so, the cross-error questioning petitioners' right to share in the fund is without merit and the Court of Appeals erred in directing otherwise.

BRIEF OF ARGUMENT.

I.

NO ACTUAL FRAUD IS SHOWN.

First, as to the preferences of the Rubber Companies.

Upon motion of the *complainant* and the concurrence of the defendants this case was referred to a master to take proofs and report the same, together "with his conclusions thereon as to the facts only." (Rec., p. 156.)

The master expressly found that there was no actual fraud in these preferences. The Circuit Court in confirming his report also so decided, Judge Grosscup saying:

"The intervening creditors have not clearly proven that the Rubber Company and the Candee Company had any intention to commit a fraud upon the other creditors at the time of the arrangement of January, 1896; on the contrary, I think the weight of proof shows that both these companies believed that, with the help they were about to give Fargo & Co., that company would be able to weather the storm. I am, therefore, of the conclusion that there was no intentional fraud committed."

Under these circumstances the master's findings, should be accepted as presumptively correct, and not be set aside unless clearly wrong.

Crawford v. *Neal*, 144 U. S., 585–596.
Davis v. *Schwartz*, 155 U. S., 631–636.

In *Crawford* v. *Neal*, *supra* (a suit to avoid a preference as fraudulent) the Chief Justice said:

"The cause was referred to a master to take testimony therein, 'and to report to this court his findings of facts and his conclusions of law thereon.' This he did, and the court, after a review of the evidence, concurred in his findings and conclusions. Clearly, then, they are to be taken as presumptively correct, and unless some obvious error has intervened in the application of the law, or some serious or important mistake has been made in the consideration of the evidence, the decree should be permitted to stand."

Upon the cross-appeal the finding of the master that there was no actual fraud was vigorously assailed but Mr. Justice BROWN, in his opinion, said:

"To make it actually fraudulent, such as to require the claims of those preferred creditors to be postponed to the claims of the general creditors, I think it should clearly appear either that the preferred claims were not *bona fide*, of which there is no pretense, or that the arrangement was entered into, not for the purpose of tiding the company over its immediate crisis, enabling it to continue business, and at the same time to secure the preferred creditors, but for the purpose of ultimately winding it up, and in the meantime of giving it credit and enabling it to purchase additional goods, which the preferred creditors would thereby be able to seize and subject to their own debts. I find no testimony to satisfy me that an actual fraud upon the general creditors was intended. * * * The evidence satisfies me that there was a *bona fide* attempt to assist the Fargo Company in continuing its business, with the hope of ultimately pulling it through, and that if this attempt had been successful, it would have redounded greatly to the interest of the general creditors."

The majority opinion of the Circuit Court of Appeals (Rec., pp. 717–734) certainly does not in terms—and we think does not intend to—overrule the master's findings of facts. True, that opinion does in one place say that "the Rubber Companies were guilty of fraud in fact," but it also says:

"Questions of fraud in law and fraud in fact are in their nature separate, though not always distinguishable by clearly defined lines. In this case * * * no attempt will be made as we proceed to keep the distinction all the while in view."

And in commenting on the language of the master's report "but not with fraudulent intent as to the other creditors of the company" the opinion says:

"If, however, the master intended, as it seems probable he did intend, to find that the parties to the scheme had no conscious purpose to harm either present or future creditors, the finding cannot abrogate or restrict the application of that familiar rule, without which a coherent code of law or morals would be impossible, that men shall be deemed to intend the natural or probable consequences of their acts or conduct. * * * The inventors of the scheme were bound to apprehend its probable consequences."

And again:

"It was hoped—let us say believed—by all concerned, that with that sum [$50,000], under the plan agreed upon, the company 'would be able to weather the storm.'"

And again:

"It was not, as alleged in the bill, a part of the plan that increased purchases should be made for the purpose of improving the security of the rubber companies."

From the foregoing and other expressions in this opinion it would seem that a majority of the Court disagreed with Mr. Justice Brown, not upon any question of fact, but upon a legal question, *i. e.*, what constitutes actual fraud. They deduce actual fraud, not from *motives* of the parties to the preferential transaction, not because of any desire or intention to commit a wrong upon the other creditors of Fargo & Co., but because of the supposed injurious *effect* of the transaction upon such other creditors—an effect rendering it illegal, *independent*

of the actual intention of the parties. The intention here made the basis of actual fraud is not an actual or conscious intention, but one imputed to petitioners as a matter of law. In its opinion the court shows no purpose to overrule the master's finding that petitioners were guilty of no *intentional* wrong nor *conscious* purpose to injure the other creditors. Thus the question of actual fraud is made to hinge, not upon *motives*, but *results*.

This seems to us to disregard the well-established distinction between actual and constructive fraud, which is recognized by this court in

Neal v. *Clark*, 95 U. S., 704–9,

where in construing the word "fraud" in the bankrupt act Mr. Justice Harlan said:

"It means positive fraud, or fraud in fact, involving moral turpitude or intentional wrong. * * * and not implied fraud, or fraud in law, which may exist without the imputation of bad faith or immorality."

But, if we are to go behind the master's report, the evidence clearly shows the parties guiltless of any actual fraud in the preferential transactions of January 6.

In determining this question fraud is not to be presumed, but to be proved by the party alleging it; the Rubber Companies must be shown to have concurred in the fraudulent intent, the intent of the Fargos alone not being sufficient (*Union Natl. Bank* v. *State Natl. Bank*, 168 Ill., 256–264; *Crawford* v. *Neal*, 144 U. S., 585–595); and conduct which is as consistent with an honest purpose as with a dishonest one does not establish fraud.

What, then, are the facts in this record bearing upon the intention of the parties in entering into the January agreement?

These Rubber Companies had done business with the Fargo Company for more than twenty years, its volume reaching in later years $300,000 per annum, and their relations were close and friendly. (Rec., pp. 495–6). The January transaction was initiated by the Fargo Company. The Rubber Companies were not asking payment or preferences, but the Fargo Company sent to them for financial assistance. (Rec. pp. 201, 496, 497.) Up to this time nothing had occurred to raise in the minds of the Rubber Companies any suspicion of the credit of the Fargo Company. (Rec., p. 510.) The Candee Company had always had the utmost confidence in the Fargo Company. (Rec., p. 502.) At the interviews leading up to the January arrangement, the Fargos represented that their company was solvent, that it had assets largely in excess of its liabilities, that, while it was embarrassed, its embarrassment was temporary only, and that with the financial assistance requested it could overcome its difficulties by May 1st following (Rec., pp. 226–227, 497, 501, 510, 520, 525, 550, 442), and they submitted to Johnson, the representative of the Rubber Companies, figures showing its assets and liabilities. (Rec., p. 226.) He testified that he believed these statements, and that otherwise he would not have entered into the arrangement. (Rec., pp. 497, 501, 507, 503, 510, 520.) The Fargos believed their statements to be true. (Rec., p. 226.) It is noteworthy that Mr. Fargo at first asked Johnson for a loan of only $25,000, that Johnson would not lend anything unless it was beyond question sufficient to carry the concern through its troubles, that he, Johnson, made the Fargos re-examine their condition to see if $25,000 would be sufficient, and that when upon re-examination it was found that $50,000 would be necessary, John-

son agreed to advance it. (Rec., pp. 200, 227, 231, 501, 502, 553). Johnson wanted to help the Fargo Company over its troubles in order to maintain through it a channel for the distribution of rubber goods. (Rec., pp. 512, 501). If, as contended, Johnson's purpose was to purchase a preference by advancing the $50,000, and to put himself in a situation to defraud other creditors rather than to help this struggling corporation through its temporary embarrassment, why did he advance $50,000 when $25,000 was all Fargo asked for?

There was no agreement, discussion or intention between the parties that the Fargo Company should proceed to increase its tangible assets, or that it should give control to the Rubber Companies. (Rec., pp. 266, 267, 268.) It was part of the arrangement that the Fargo Company should reduce its general indebtedness, contract its business and proceed on economical and conservative lines. (Rec., pp. 232, 233, 506, 558.) This is not consistent with the contention that the purpose of the arrangement on the part of the Rubber Companies was to "rope in" creditors and thereby secure assets to levy upon.

It was also stipulated by Johnson that the $50,000 to be advanced should be used in reduction of the general indebtedness of the company as it matured. (Rec., p. 445.) In January there was no intention of ceasing business at any time (Rec., pp. 266, 267), for the Fargo Company expected to be relieved of its embarrassment by May 1 1896 (Rec., pp. 231, 232), and the whole conduct of the parties is consistent with such expectation. Charles E. Fargo, (a witness for respondents) who was the manager of the company and chiefly carried on the negotiations for it, testified that the sole purpose of

the January arrangement was to help the company over its embarrassment. (Rec., pp. 229, 230.) The uncontradicted testimony is that the change of the board of directors was only a part of the preferential security and was only for the purpose of giving assurance to Johnson that the Fargo Company would not violate its contract with the Rubber Companies by giving other judgment notes, etc., to undermine or impair the preference contracted for. (Rec., pp. 241–501, 505.) This change was suggested by Fargo himself as an evidence of his good faith in promising not to impair the security of the judgment notes. (Rec., pp. 295–6, 551.)

The arrangement did not provide, and it was not the purpose of the parties, that the Rubber Companies should in any way control, interfere with, or have knowledge of, the business of the Fargo Company after the arrangement was made. When it was concluded on January 6th the representative of the Rubber Companies went back to New York and left the Fargos entirely free to manage the business as before. (Rec., 506.) Charles E. Fargo also testified, and all the circumstances combine to support his statement, that after the arrangement was made the business was carried on solely for the benefit of the Fargo Company, and not at all for the benefit of the of the Rubber Companies. (Rec., pp. 251, 268–269.) The Rubber Companies and the new directors had no knowledge of how the business was managed after January (Rec., p. 269), it having been managed, as theretofore, by consultation of the three Fargos, the owners of the entire capital stock. (Rec., p. 246.) If the Rubber Companies entered into this arrangement to use the Fargo Company for their own benefit, would they not have taken steps to control the management of the assets for that purpose?

But let us see how the business as a whole was managed after the arrangement in January; for this should throw strong light upon the intentions of these parties. Pursuant to the contract the business thereafter was contracted, the salaries of the Fargos were reduced one-half (Rec., p. 233), and the total liabilities of the company to its general creditors (that is, to others than petitioners) were decreased to the extent of $67,524.22. (Rec., p. 458.) This reduction of liabilities means a corresponding reduction of assets, and in itself refutes the contention that the Rubber Companies entered into the arrangement in order to *swell* the assets subject to levy.

But what was the effect of the business thereafter upon the indebtedness to the Rubber Companies? On January 6th, before the arrangement and before the advance of the $50,000 was made, the entire amount due the Rubber Companies was $186,427.61, while on August 6th and to-day the aggregate amount is $178,954.81, a reduction of but $7,482.32 (Defendants' Exhibit 19, Rec., p. 595.) During this same period the Fargo Company paid out in cash in the ordinary course of business over $310,000 to its other creditors. (Rec., p. 458.) It paid off nearly the entire indebtedness existing on January 6th to the general creditors, who are substantially the same persons who are now the complaining creditors (Rec., p. 293), and it also incurred about $242,000 of new indebtedness to the merchandise creditors, of which less than $150,000 remains unpaid. (Rec., p. 458.) *These figures establish incontrovertibly that during this period the business of the Fargo Company was carried on in the interest of its stockholders and creditors generally, and not of the Rubber Companies.*

The figures quoted also show that the Fargos expected to overcome their embarrassment. This is corroborated by the fact that in March or April 1896, they enlarged the manufacturing plant of the company by building a new addition at an expense of $7,000. (Rec., p. 223.) Some notes of the company ($15,000) upon which the Fargo brothers were sureties were paid in the regular course of bnsiness, but there is no evidence that they individually profited to the extent of a dollar from the assets by this January arrangement. During this period the United States Rubber Company continued to do business with the Fargo Company as theretofore, supplying all its wants, and the Fargo Company paid it on account of the indebtedness of January 6th, $15,000; but it during that period also sold consigned goods of the United States Rubber Company amounting to $24,534.04, of which it remitted only $5,495.40 (Defendant's Exhibit 19, Rec., p. 595), so that the business between January and August resulted in an increase in its indebtedness to the United States Rubber Company.

THE METROPOLITAN BANK WAS NOT GUILTY OF ACTUAL FRAUD.

The master found that "the Metropolitan National Bank was not shown to have been guilty of actual fraud as against * * * the complainant or the other creditors of C. H. Fargo & Co., by reason of any of its transactions with the said defendant C. H. Fargo & Co. or the said Rubber Companies," and "that there was no fraud in fact or want of good faith in the conduct of any of the defendants in respect to the transactions complained of."

This finding was endorsed by Judge Grosscup and tacitly approved by Mr. Justice Brown. Indeed the majority opinion, as we read it, does not find the bank guilty of actual fraud.

It does apparently dissent from the finding of the master that neither the bank, nor its officers, nor attorneys, had any knowledge of the change of directors or by-laws, upon the ground that there is no evidence that the bank or such officers did *not* have such knowledge, and also that the bank's president was put upon inquiry. If this is referred to to show actual fraud, it overlooks the principle that fraud must be affirmatively proved by the one alleging it. If therefore such knowledge is here an element of fraud, it should have been affirmatively proved by respondents. Fraud cannot be deduced from the absence of evidence on this subject. So, too, actual fraud cannot be predicated upon mere constructive notice or knowledge. Certainly the matters here referred to are insufficient to overturn the master's finding that the bank was guiltless of actual fraud. The bank's preference will be further considered under the question of constructive fraud.

Hence, if the evidence is to be looked into, no case of actual fraud is shown.

II.

THERE WAS NO CONSTRUCTIVE FRAUD.

The question here is whether upon the facts found by the master these preferences are *constructively* fraudulent.

In the discussion of this question the following legal propositions are not questioned by the lower courts or respondents' counsel:

(1) These preferences, made in Illinois by a corporation of that state, are to be tested by the law of Illinois so far as declared.

Peters v. *Bain*, 133 U. S., 670.
Allen v. *Massey*, 17 Wall., 351.
Smith Purifier Co. v. *McGroarty*, 136 U. S., 237.

(2) The right of an individual debtor on the eve of failure to prefer one creditor to the exclusion of others exists in Illinois to its fullest extent.

Tomlinson v. *Matthews*, 98 Ill., 178.

(3) An Illinois corporation, although insolvent and contemplating ceasing business, has the same right as an individual to prefer creditors other than directors.

Reichwald v. *Commercial Hotel Co.*, 106 Ill., 439–451.
Gottlieb v. *Miller*, 154 Ill., 44.
Glover v. *Lee*, 140 Ill., 102.
Warren v. *First National Bank*, 149 Ill., 9.

(4) An Illinois corporation, if contemplating the continuance of its business, may, although insolvent, give judgment notes to its directors for a present loan of money.

Illinois Steel Co. v. *O'Donnell*, 156 Ill., 624.

Whether such corporation could give to a director a preference in part covering a pre-existing debt and in part for money advanced to aid the company to continue its business has not yet been decided by the Illinois court. In the absence of such decision that of this court in *San-*

ford Tool Co. v. *Howe*, 157 U. S., 312, upholding such prefence *in toto*, should control.

(5) Debts for which the directors are liable as endorsers, etc., may be preferred by an Illinois corporation on the eve of its failure.

Blair v. *Illinois Steel Co.*, 159 Ill., 350.
Rockford Co. v. *Standard Co.*, 175 Ill., 89.

(6) Directors may be relatives of the preferred creditors without invalidating the preference.

Ragland v. *McFall*, 137 Ill., 81.
Illinois Steel Co. v. *O'Donnell*, *supra*.

(7) The giving of judgment notes is recognized in Illinois as a legitimate method of preference.

Field v. *Ridgely*, 116 Ill., 424.

Hegeler v. *Bank*, 129 Ill., 157.

In the light of these legal principles it is proposed now to examine separately the preferences to the Rubber Companies and the Metropolitan Bank.

First as to the Rubber Companies. To these the rule prohibiting directors from preferring themselves when contemplating a cessation of business has no application. The preferences of the Rubber Companies were not to directors. In granting them Fargo & Co. and the Rubber Companies dealt at arm's length. None of its directors or officers were either directly or indirectly connected with the Rubber Companies. Their preferences were not a result of the election of the directors nominated by Mr. Beale. On the contrary, the election of such *new* directors was the result of the contract for preferences previously made by Fargo & Co. through its old directors. The new directors by no vote or act contrib-

uted to, or participated in, the giving of these preferences, nor were they interested in, or benefited by, them. Besides, they were given when Fargo & Co. was a going concern and not contemplating failure.

This is equally true of the assignment of the accounts. While the actual assignment thereof was not made until August 6, it was then made by the president, in obedience to a resolution passed by the old directors on January 6. The new directors did not participate in it.

The conditional promise to assign by way of preference, should the company find it necessary to suspend business, was valid.

In *Smith* v. *Craft*, 17 Fed. Rep., 705, a similar undisclosed promise, although attacked as fraudulent, because giving a delusive credit, was held not to invalidate the preference given in performance thereof, and this court (*Smith* v. *Craft*, 123 U. S., 436) upon a certificate of division in another case involving the same failure, held such undisclosed promise to prefer, followed by a preference, was not *per se* or constructively fraudulent.

In *Feckheimer* v. *Baum*, 43 Fed., 719, the court, in speaking of an undisclosed agreement to prefer, which was claimed to have given the creditor a delusive credit, said:

"This instrument is nothing more than an agreement to prefer in case of insolvency. The law of Georgia authorizing an insolvent debtor to prefer a creditor, it is difficult to perceive why a promise to prefer in itself can be regarded as the beginning of a fraud. * * * Here the instrument was merely a promise to give a mortgage. There is no provision of the state law for record of such paper. * * * We know of no obligation which required Comer & Co. to publish such an agreement had with one of their customers."

See, also,

National Bank v. *Whitmore*, 104 N. Y., 297.

The contract being legal, it was not only the right, but the duty, of Fargo & Co. to carry it out. Having obtained money on the faith of it, it would have been dishonest not to fulfill it. This duty did not become less because the board of directors changed after the promise was made. In fact the new directors did nothing to carry it out, and could not properly have done anything to prevent its being carried out, but had they participated in the actual assignment in August, there could be no legal objection to it. The rights of the parties and the validity of preference acquired under the contract to prefer should be fixed as of January. Performance in August should relate back to the prior legal promise.

National Bank v. *Whitmore*, *supra*.
Clark v. *Iselin*, 21 Wall., 360.
Hauselt v. *Harrison*, 105 U. S., 401.
South Branch Co. v. *Ott*, 142 U. S., 622.
Douglas v. *Vogeler*, 6 Fed. Rep., 53.

Hence, the preferential assignment of accounts is to be regarded as made in January, and its validity is to be decided by the same legal principles which apply to the January judgment notes.

All the judges below held the Rubber Companies' preferences constructively fraudulent, although differing somewhat in the grounds therefor. Judge Grosscup held that neither the giving of the judgment notes nor the assignment of the accounts in itself, constituted a fraud.

"The vice in the conduct of the Rubber Company and the Candee Company consists in their attempting to

tie up the corporation against the power to give like preferences in favor of others." (Rec., p. 636 b.)

The other learned judges seem to have treated the fact that the preferences were kept secret as in itself itself an independent element of fraud. It is, however, safe to asssert that all the judges below tacitly concede that, if secrecy and the change of directors and treasurer were absent, the preferences to the Rubber Companies would be valid under the laws of Illinois. Do, then, either of these elements make the preferences constructively fraudulent?

SECRECY AS AN ELEMENT OF FRAUD IN THE PREFERENCES.

On this point the master found as follows:

"The matter was kept secret in order to allow Fargo & Co. an opportunity of getting through embarrassments apparently temporary, but not with a fraudulent intent as to the other creditors of the company."

This finding (which refers to conscious intent) is amply sustained by the evidence, and we do not understand that its correctness is questioned by the lower courts. The only conceivable *fraudulent* intent or motive in keeping the matter secret would be to thereby purchase goods on credit to subsequently levy upon; but the majority opinion says:

"It was not, as alleged in the bill, a part of the plan that increased purchases should be made for the purpose of improving the security of the Rubber Companies."

It is not claimed that there was any agreement for secrecy, but Judge WOODS says:

"The master's finding on the point implies, and the evidence demonstrates, a *mutual understanding* between those concerned that secrecy was necessary, and an ex-

press agreement that it should be kept would not have made the understanding more clear or its fulfillment more imperative. * * * Secrecy kept for a purpose is not accidental or unintended; it is premeditated; it is in essence the same as if agreed upon."

Thus the learned judge seems to assert that in Illinois *intentional* secrecy in itself renders a preference fraudulent, that secrecy kept for a purpose—however commendable that purpose—avoids a preference, and that intentional secrecy, although solely for the purpose of enabling a corporation to get "through embarrassments apparently temporary," is fraudulent.

Whatever be the decision in other states—and in them there is some conflict and confusion—it is certainly beyond question that in Illinois intentional secrecy in a preference, although followed by the giving of credit which without it would have been withheld, is not a fraud on the creditors unless the *motive* is fraudulent. A preferential agreement kept secret with a legitimate motive, or for a legitimate purpose, is not fraudulent although it is followed by the giving of credit that would otherwise have been withheld. The policy of the law in Illinois is firmly settled. It recognizes the right (as does this court in *Sanford Tool Company* v. *Howe*, *supra*) of an embarrassed debtor, whether individual or corporation, to struggle to outlive financial embarrassment. It appreciates that this struggle requires the continuance of purchases on credit. It recognizes the right of such a debtor to give judgment notes, and does not—as it does in the case of mortgages—provide by statute for any public notice thereof. It exacts of an embarrassed debtor no unsought disclosure of outstanding judgment notes. It here imposes upon the creditor the duty of inquiry from his debtor. It condemns the keeping secret of

judgment notes, where the purpose is to increase the assets to levy upon, for here the *intention* is wrongful, but it upholds judgment notes intentionally kept secret, although followed by purchases on credit, where the purpose is honest—the continuance of the business in the expectation of outliving embarrassments. It allows, as Judge Grosscup concedes (Rec., p. 84, 85) "preferences, and such preferences as are necessarily unknown to others than those concerned." As he says, "A debtor can prefer one or more of his creditors without changing his personal aspect toward the stock in trade, or the public at large."

The test in Illinois is not whether the secrecy is intentional or not, but whether the purpose of the secrecy is honest or dishonest. To hold otherwise would be to practically inhibit the giving of judgment notes—a very general form of security in Illinois. Such notes are usually intentionally kept secret. To require their existence to be proclaimed would in many cases destroy credit and precipitate failures, and thus deprive an insolvent debtor of an opportunity to outlive financial embarrassment.

The position of the Circuit Court of Appeals that secrecy kept for the purpose of enabling Fargo & Co. to outlive embarrassments is fraudulent because it gave rise to a fictitions credit is opposed to the Illinois law, as the two following cases show:

In *Hegeler* v. *First National Bank of Peru*, 129 Ill., 157, the facts and the contentions of the attacking creditors, except in the feature of the change of directors, were strikingly like those in the case at bar. An insolvent corporation offered to secure a debt to its bank by mortgage, but this the bank refused, "*because it would in-*

jure the credit of the glass company and prevent it from obtaining elsewhere further credit," and in lieu thereof took from the company judgment notes for its indebtedness. *Here was a clear case of intentional secrecy to avoid injury to credit.* These notes were retained without the entry of judgment thereon *for more than a year.* The corporation during this time continued its business, and the attacking creditors advanced the corporation money upon false statements by it of its financial condition, and, as was claimed, "upon the delusive and fictitous credit given it by said First National Bank of Peru [the preferred creditor], in allowing it to retain all its property apparently free from incumbrance," and that, had the attacking creditors "known or suspected the existence of such judgment notes, they would have given no credit or loan whatever to such glass company;" and that "such concealment enabled the debtor to deceive and mislead other persons to give it credit that would otherwise have been withheld." But the court upheld the preferential judgment, saying (the italics ours):

"The argument proceeds throughout upon the proposition that the bank took its notes and held them under circumstances that made its conduct operate as a fraud upon others. There is no pretense that there was any agreement to conceal its claim against the glass company, much less that any such agreement was made for the purpose of enabling the company to obtain credit from others. No evidence can be found in the record proving, or tending to prove, acts or declarations on the part of appellee calculated to induce appellant to give credit to the glass company. There is nothing in the bill, and certainly nothing in the evidence, to show that at the time appellee took its notes and refused to take mortgage security, it did not honestly believe that, notwithstanding the insolvency of the glass company, it would, *if its credit could be maintained*, successfully recover from its embarrassment, continue business, and pay all its debts."

In *Field* v. *Ridgley*, 116 Ills., 424, a firm largely in arrears to a creditor executed to him judgment notes and thereafter continued as before to conduct an extensive mercantile business on credit *for four years*, when it failed. Judgments entered on these notes were attacked as a fraud on creditors in that they had been induced to sell goods to the firm when insolvent, a fact known to the judgment creditor, but not to the attacking creditors; but the court upheld the preference, saying,

"The acts of fraud relied on * * * are no evidence of fraud at all. * * *

"As to the complaint that appellees held the notes so long without giving notice of their having them, we perceive no force in it. There is no law or mercantile usage, so far as we are advised, that requires one in business to disclose the state of his accounts with his customers to others having dealings with them, and there are manifest reasons why this should not be done except when the creditor is specially interrogated on the subject by one having a personal interest in knowing. It is not charged in this case that appellants ever sought any information of appellees [judgment creditors] in respect to the claims of the latter against Kimber, Ragsdale & Co., or that they ever said or did anything, outside of what we have already stated, to mislead appellants with respect to Kimber, Ragsdale & Co.'s indebtedness to appellees, or in respect to the manner in which such indebtedness was secured. The forbearance of a creditor to crush out a struggling debtor upon the first opportunity, with a view of enabling him to overcome business misfortunes, ought not to be converted by judicial construction into a species of fraud. On the contrary, so long as the creditor's conduct is characterized by good faith, as was evidently the case here, such forbearance should be regarded by the courts with favor, rather than otherwise.

As respects even preferential securities, for the recording of which the Illinois law makes provision, mere intentional withholding from record is not *per se* fraudulent.

Field v. *Ridgely*, 116 Ill., 424.

Haas v. *Sternbach*, 156 Ill., 44.

In the former case, where a mortgage was attacked as fraudulent because withheld from record for five years, the court upheld it, saying:

"We are aware of no principle outside of self-interest and prudence in business, that requires the holder of a mortgage to put it on record at any particular time."

In the latter case, the court said:

"It cannot, therefore, be said that the mere omission to record is fraudulent *per se* as to subsequent creditors of, or purchasers from, the mortgagor. * * * If withholding an instrument from record is fraudulent because of an agreement or other reason for so doing, it is not so *per se*, but in fact. In other words, whenever the motive is involved, the question becomes one of intention —actual fraud as distinguished from fraud in law— and so the question has generally been presented and disposed of."

Thus, in Illinois, it is the settled law that intentional secrecy respecting a preference without "fraudulent intent as to other creditors" does not make it constructively fraudulent.

This court has, in effect, held the same doctrine.

In *Smith* v. *Craft*, 123 U. S., 436, already referred to, the promise to prefer was kept secret and was unknown to the attacking creditor at the time he gave credit to the debtor, and yet this court held this not fraud *per se*, but only voidable in case of actual fraud.

See, also, *Sawyer* v. *Turpin*, 91 U. S., 114.

This court, in *Sanford Tool Company* v. *Howe*, 157 U. S., 312, as well as the Circuit Court of Appeals (speaking through Mr. Justice Harlan) in *Sutton* v. *Hutchinson*, 63 Fed. Rep., 496, recognized the right of an embarrassed corporation to try to outlive its financial difficulties, and for that purpose to give securities which might ripen into preferences in case of failure. This right would be very unsubstantial, if the law couples with it

a duty of the company to make public its embarrassment and the means it is resorting to to overcome it. In the case at bar, as Mr. Justice Brown says, "publicity doubtless would have destroyed the entire scheme of raising money to carry on the business."

Fargo & Co. through the $50,000 of new money it obtained in January, and because its real condition was not known by its general creditors, was enabled for several months to continue its struggle to live and pay its creditors in full. Had it succeeded—as many corporations similarly situated have done—none would have questioned the honesty of its conduct. This emphasizes the fact that secrecy concerning such arrangements by insolvent debtors is not of itself a fraud. Doubtless it may be an element of fraud, but it is as often the means of *preventing* the failure of embarrassed debtors. It is therefore the purpose or intent, not the fact, of secrecy, that should control.

What is here said of secrecy concerning judgment notes is equally true of the secrecy respecting the change of directors. The law of Illinois did not require public notice of a change of directors. Creditors were left to ascertain by inquiry, if to their interest to do so, the personnel of the directory.

It follows that, as the secrecy concerning the January transactions was without fraudulent or dishonest motive, the preferences to the Rubber Companies cannot upon the ground of secrecy be held constructively fraudulent.

Did the change of directors make the preferences to the Rubber Companies constructively fraudulent?

The facts concerning this are as follows:

The Fargo Company in the January arrangement

agreed that "it should not give any judgment notes to other creditors which would impair the security of the Rubber Companies," that five of the then directors should resign and the stockholders should elect five new directors, to be nominated by Mr. Beale, and that "the directors so to be elected at Beale's nomination should not hamper or interfere with the proper carrying on of the ordinary business of the company," that "the only purpose and object of changing the board of directors as aforesaid, and amending the by-laws [by vesting in the directory the exclusive power to give judgment notes, etc.] was to protect the Rubber Companies against the giving by the Fargo Company of preferential security or judgment notes, which should be superior to the security of the Rubber Companies," that "the arrangement as made was carried out in good faith by the parties, and that the directors elected at the suggestion of Mr. Beale took no part in the active management of the Fargo Company after their election, and that no directors' meetings of Fargo & Co. were held after January 9, 1896, until August 5, 1896." These findings of the master are not controverted by the lower courts. Mr. Justice BROWN said (Rec., 736): "The device of changing the directors was evidently not for the purpose of giving up control of the business, but only to secure the arrangement that no other judgment notes should be given, and, as a matter of fact, the new directory did not interfere with the business of the company as conducted by the Fargos. Indeed, no meeting of the directors was held after the change was made." The evidence is undisputed that after the election of these directors, as well as before, the business was managed and conducted by the three Fargos in the interest of the

company and to the advantage of its creditors generally. (Rec., 162.)

Furthermore no injury to the creditors from this change of directors is shown. It does not appear that the Fargos during this period wished or were willing to prefer any of the other creditors, except the Metropolitan National Bank. When in August they desired to prefer that bank the new directory by a resolution authorized it; and, as stated by Judge GROSSCUP (Rec., 636 B.), "none of the other creditors attempted to obtain such [judgment] notes or any other preference before the general crash," and the arrangement "did not do any actual injury to the other creditors."

What then is here disclosed is simply an agreement made by a "going" corporation that a preferential security (through which a new loan was obtained with which to continue business and attempt to overcome embarrassment) should not be impaired by preferential judgments to other creditors, a change of directors *solely for the purpose of assuring the performance of this agreement*, and the absence of any actual injury resulting therefrom to the company's other creditors.

The question thus presented is whether this change of directors for the purpose and to the extent above indicated is constructively fraudulent when made, as the master finds, in good faith and without actual fraud.

This change of directors was not *per se* fraudulent regardless of the motive or purpose. In Illinois the right to elect directors is vested exclusively in the stockholders, whose motives the law does not concern itself with. They certainly may elect directors with a view to inspire

in those with whom the company deals a confidence that its contracts will be fulfilled. They may—and frequently do—elect such directors as those dealing with the company nominate or suggest.

In *Kitchen* v. *R. R. Co.*, 69 Mo., 224 (page 242), an agreement that capitalists about to advance money to an embarrassed railroad company should have a "controlling voice in the directory in order that the money "furnished might be thus [as agreed] applied and result "in giving them ample security for their investment," was held not constructively fraudulent.

See also,

Leavenworth v. *Chicago Ry. Co.*, 134 U. S., 704.

So the stockholders of a corporation can, in their discretion, select as its directors some of its creditors. There is no inconsistency in one's being at once a creditor aud a director. The law permits a director to deal with his company and thereby become its creditor.

Harts v. *Brown*, 77 Ill., 226.
Sandford Tool Co v. *Howe*, *supra*.

Why may not, then, a creditor become a director if the stockholders wish it? Even if these Rubber Companies had been partnerships and five of their members had been elected directors, this would have infringed no right of creditors.

But the persons elected directors were not creditors, but clerks in the office of the counsel of the Rubber Companies, one being also assistant Corporation Counsel of the City of Chicago, and they were elected by a unanimous vote of the stockholders. It is not

claimed that they were not by character and capacity qualified to be upright and intelligent directors; nor is there any evidence that they were, or were expected to be, improperly influenced in discharging their duties as directors by this relationship to the attorney of the Rubber Companies. At most it only gave the attorney a certain moral influence.

But such moral influence, even in the case of stockholders whose votes elect the directors, is neither illegal nor justifies the charge that the directors are "controlled" in any improper sense by those who elect them.

Leavenworth v. *Chicago R. Co.*, 134 U. S., 688, 704 *et seq.*

Porter v. *Pittsburg Bessemer Steel Co.*, 120 U. S., 649.

Pullman Palace Car Co. v. *Missouri Pacific*, 115 U. S., 587, 596.

Higgins v. *Lansingh*, 154 Ill., 357.

Bank v. *Allen*, 33 C. C. A., 169.

In the last of these cases (which in many of its features resembles the case at bar) the preferred creditor was a bank, and the debtor a mercantile company, whose business was conducted by its president, who was one of three directors, the other two being the bank's assistant cashier and a bookkeeper recommended to the debtor by the bank, and the bank held most of the stock of the mercantile company as security, but the Circuit Court of Appeals for the Eighth Circuit, in upholding the preference, said:

"In view of these considerations, we are unable to discover any reasons which will warrant a ruling that the control which the bank exercised over the mercantile company was tantamount to a secret lien on its property,

and for that reason fraudulent. Such influence as it exercised over the mercantile company it had acquired by means which the law esteems lawful. It concealed no fact which the law required it to make known. Moreover, it had no legal power to control the corporation, since the majority of that company's directors were under no obligations to the bank which can be assumed to have rendered them unduly subservient to its wishes."

Nor will the law assume in the absence of proof that these directors—although elected upon the nomination of Mr. Beale—were to, or would, act illegally or fraudulently.

Allen v. *Wilson*, 28 F. R., 677
Rogers v. *Nashville Ry. Co.*, 91 F. R., 299, at page 313.

Clearly, then, the creditors of Fargo & Co. cannot complain of the mere selection by its stockholders of Mr. Beale's nominees as directors. It being lawful for stockholders to select them, it was not unlawful to *agree* to do so. Hence neither the agreement to elect, nor the election of, these directors constituted in *itself* a legal fraud.

Not that the selection of directors may not be a part of a fraudulent scheme. In such case, however, it must be a means to a fraudulent end. There the fraud arises—not from the fact of such selection—but from its purpose. As the "only purpose and object" of this change of directors was to carry out the company's agreement not to give their other creditors an equal or superior preference, the real question is whether such an agreement is a fraud on its other creditors.

While all the learned judges in the lower courts seem to have regarded the change of directors as an element of fraud, the opinion of but one (Judge GROSSCUP) states the reasons therefor. He says (Rec., p. 636 a):

"The vice in the conduct of the Rubber Company and the Candee Company consists in their attempting to tie up the corporation against the power to give like preferences in favor of others."

The supposed vice, then, when this transaction is fundamentally considered, is not the change of directors, but the agreement to restrict Fargo & Co.'s power to prefer other creditors. The question, then, is not confined to corporations, but concerns individuals as well. A corporation's right to prefer creditors (other than directors) is identical with that of an individual. Hence, the creditors of an individual are as much wronged as the creditors of a corporation, by an agreement or other pre-arranged purpose to "tie up" their debtor's power to prefer them.

Hence the real question is whether an agreement or arrangement by a debtor, either individual or corporate, that a preferential judgment note (in part securing a present loan) should not be impaired by subsequent preferences to others, is a fraud upon *creditors*. If so, it must be—since every wrong implies the existence of a right—because it infringes some *right* of the creditors.

What right of creditors, then, is here infringed? This involves the consideration of what, and whose, is this right to prefer. Property includes the right to dispose of (as well as use) the thing possessed. This right to transfer includes the right of a debtor to assign his property to his creditor in payment of, or as security for, his debt. This latter right—commonly known in the case of an insolvent debtor as the right to prefer—continues so long as the owner retains dominion over his property. It is subject to but two limitations—the right of the state to provide by bankrupt or insolvent laws for the ratable distribution of an insolvent's estate, and a limitation pro-

hibiting conveyances by him with the intent to hinder, delay or defraud creditors. Subject to these two limitations—well established long prior to the adoption of the Federal or any state constitution—this right to prefer is as completely within the constitutional guaranty of protection as any other property right.

This right to prefer, being based upon *jus disponendi* which the owner of property retains so long as his ownership continues, precludes the idea that a debtor's creditors have any legal interest in its exercise. It is exclusively the debtor's. He may exercise it or not, as he pleases. His motives cannot be inquired into. He may, if the debt be *bona fide*, exercise it as to all, or a part of the property, at any time he sees fit, and in favor of any one, even the least meritorious, of his creditors. His exercise of it, or his failure to exercise it, or his exercise of it in a particular way, infringes no right of his creditors.

Is it not then illogical to say that a debtor, may not, especially to obtain a loan, submit to a self-imposed restriction upon his future power to prefer, or may not stipulate for the order of priority of his preferences—which is all Fargo & Co. did in this case?

He may by non-action, or by an actual transfer of all his property to one creditor, or by giving one judgment note of sufficient size to absorb his entire assets and afterwards refraining from giving others, perfer exclusively one creditor. So by the actual exercise of his power to prefer (in point of time or otherwise) he may in fact lawfully create such order of priority in his preferences as he sees fit. If so, how is it unlawful for him to agree to do so?

If it infringes the right of creditors "to tie up" the debtor's right to prefer, then an agreement by Fargo & Co. in January to give no preferences *at all* in case of subsequent failure would have been equally illegal. All this is repugnant to the very nature of the right to prefer.

The position of the lower courts on this point seems based upon a supposed right of creditors to have this power to prefer kept free and untrammeled, at least until exercised in a public manner. If such right exists it involves—in the case of a corporation—a correlative duty of its directors. If its creditors have this right, they must be allowed to insist that directors—from whom their preferences must emanate—should not in dealing with their corporation place themselves in a position where their self-interest will conflict with this duty to creditors.

Such is human nature that no corporation will often give a preference to others that impairs previous preferences to a majority of its directors. Here is a situation arising from self-interest that is as potent "to tie the hands of the corporation against the power to give like preferences in favor of others" as would be an agreement of the corporation. If one is fraudulent equity must also condemn the other.

Hence, this new theory, if it is to be engrafted upon the law, must be carried to its logical conclusion by annulling all preferences to directors, especially to a majority of the directors.

But this is inconsistent with *Sanford Tool Co.* v. *Howe*, 157 U. S., 312, and *Illinois Steel Co.* v. *O'Donnell*, 156 Ill., 624.

In the *Sanford Tool* case an insolvent, but "going,"

corporation gave in good faith, and with a view to continuing its business, a mortgage upon its manufacturing plant to indemnify a majority of its directors for their endorsements of prior notes, and on account of moneys thereafter to be, and subsequently, advanced. In the Circuit Court (44 Fed., 231), Judge Woods held the mortgage a fraudulent preference, saying: (italics ours.)

"Whether or not such preferences are fairly given is an impracticable inquiry, because there can be in ordinary cases no means of discovering the truth; and consequently, the presumption to the contrary should in every case be conclusive. Concede that it is a question of proof, and that a preference in favor of a director will be deemed valid if fairly given, and it may as well be declared to be a part of the law of corporations that in case of insolvency debts to creditors and liabilities in which they have a special interest must be first discharged. That will be the practical effect, and the examples will multiply of individual enterprises prosecuted under the guise of corporate organization, for the purpose, not only of escaping the ordinary risks of business, done in the owner's name, which may be legitimate enough, but of enabling the promoters and managers, when failure comes, to appropriate the remains of the wreck by declaring themselves favored creditors. Besides inconsistency with that equality which equity loves, such favors involve too many *possibilities* of dishonesty and successful fraud to be tolerated in an enlightened system of jurisprudence."

Compare the foregoing with the following from the opinion of Judge Woods in this case: (italics ours.)

"As a judicially sanctioned or commercially accepted *possibility* in business it is unbelieveable. It could be attempted only by a corporate debtor, and its approval by the courts would afford a new and fruitful motive for the creation of corporations by the many who would be quick to avail themselves of so promising a method of pursuing hazardous enterprises at the risk of others" and it will be seen that the learned judge has applied

the same reasoning to the decision of both cases. In neither is the preferential transaction judged by its own facts and with reference to the actual intention of the parties to it. In both it is the "possibility" in other cases that condemns. Each case is not allowed to stand upon its own bottom, but transactions which are perfectly honest and entered into in good faith in order to enable the corporation to outlive, if possible, present embarrassments, are vigorously condemned because *other* cases might be dishonest and difficult to prove so.

When the *Sanford Tool case* reached this court, it rejected this line of reasoning, upheld the preferential arrangement Judge Woods had condemned, and thereby established the principle that each such case must be decided upon its own facts, and that a preferential arrangement, *even with directors*, for the purpose in part of getting new money with which to strive to outlive present financial embarrassment, when entered into in good faith, must be upheld.

This is in harmony with the tendency of this and other courts not to hold transfers to creditors as constructively fraudulent, but to make each such transfer depend upon the actual intention therein.

Etheridge v. *Sperry*, 139 U. S., 266–278.
Huntly v. *Kingman*, 152 U. S., 527–532.
Smith v. *Craft*, 123 U. S., 436.
Jewell v. *Knight*, 123 U. S., 426.

In the first of these cases where the question was whether, as a matter of law, a mortgage given by a merchant on his stock of goods to his creditor was invalidated by a parol understanding that the mortgagor might use the proceeds of his sales to support himself and keep up the stock by purchase, this court (Mr. Justice Brewer) said:

"The fact that fraudulent relations are possible is hardly a sufficent reason for denouncing transactions which are not fraudulent. So if the question were open or a new one unaffected by any settled law of the state, we incline to the opinion that the question is not one of law so much as it is one of fact and good faith, and that the decision of the Supreme Court of Iowa rests on sound principles."

So measured, the transaction at bar must be upheld, While in January the corporation was insolvent, as subse quent events proved, all the parties entered into the arrangement in good faith and with a view to aiding the company to outlive what was supposed to be its temporary embarrassment. While old indebtedness was secured, new money was also thereby obtained. It cannot in this respect be differentiated from the *Sanford Tool case*.

The *Sanford Tool case* is like the case at bar in another particular yet to be noted. The preferences there were to a *majority* of its directors. This was also true in *Illinois Steel Company* v. *O' Donnell*, *supra*, where judgment notes given to *three* of its five directors (and kept secret for several months) by an insolvent, but "going," corporation, to secure or prefer them for a present advance of money made to enable the company to continue its business, were upheld by the Supreme Court of Illinois.

In both the *Sanford Tool* and the *O' Donnell* cases the preferred creditors continued to be directors until the failure, and the effect of the preferences was "to tie up the corporation against the power to give like preferences in favor of others." True, there was no *agreement* to this effect, but it was the self-interest of the directory in each of these cases not to give others preferences which might impair their own. In legal effect the cases can-

not in this respect be distinguished from the case at bar. The agreement at bar, supplemented by the election of directors from the office of the Rubber Companies' counsel, did not create one iota more of "inability" by the corporation to subsequently "give like preferences" than existed in the *Sanford Tool* and *O'Donnell* cases. This inability, in each case, arose from the composition of the board of directors, supplemented in the case at bar by an agreement, and in the others by self-interest. Had the Rubber Companies been firms, and had five of their members been elected directors instead of clerks from their counsel's office, this agreement would have added nothing to the situation. Their self-interest would have been sufficient. In that event this case would have differed from the *Sanford Tool* and *O'Donnell* cases only in that the interested directors in the latter cases were elected before the preferences were given, and, in the present case, afterwards. The supposed unlawful result, however, would be the same.

This position of the lower court is equally at variance with the cases which sustain an undisclosed preference to a single director. For if creditors of a corporation are entitled to the unbiased and free exercise of the right to prefer, this is likewise impaired (although in lesser degree) when *one* director is preferred.

It is therefore respectfully urged that neither the change of, nor the agreement to change, directors made these preferences fraudulent.

It is also said in the majority opinion of the Court of Appeals to have been a fraud upon the law to constitute directors and a treasurer who from the beginning were "pledged not to give attention to their duties, or to

participate in the management of the business of the corporation further than to protect the rights of particular creditors, in whose interest alone they were given their places."

This alleged pledge is not here treated as an evidentiary fact. As such the master doubtless gave it its proper weight when deciding there was no fraud in fact. But it is here made an independent, and in itself sufficient, ground of fraud in law; and in that light, it is proposed now to consider it.

As respects the treasurer, the question does not arise upon this record. The bill does not aver, the master's report does not recite, and the exceptions to the master's report do not claim, that the treasurer was pledged to neglect his duty or refrain from participating in the management of the business.

Nor is there anything in this record to sustain the charge that the directors were pledged not to give attention to their duties. All that it shows is an agreement (see master's report) that the directors "should not hamper or interfere with the *proper* carrying on of the *ordinary* business of the company."

Nor is there evidence that these directors did in fact fail to give attention to their duties. All that is disclosed is that they elected the officers and thereafter "took no part in the *active management* of the company." This constituted no failure to discharge their duties.

The duties of directors involve only the exercise of general corporate powers. The law does not require them to actively participate in the conduct of the company's business. They fully meet the requirements of their office in this respect when they select officers and agents to conduct the business.

But this position, it seems to us, is based upon a misconception of the legal rights of creditors respecting the internal management of a corporation. By "fraud on the law," must be here meant fraud upon the creditors. Creditors may avoid a fraudulent conveyance by a corporation. Beyond this no cause of action arises in favor of crediors by reason of the management of a corporation. Neglect of duty by an officer or director, or even the failure to elect an officer or director, gives creditors no cause of action. Stockholders and their representatives, the directors, may exercise their own discretion in selecting, and in fixing the amount of active service required of, a treasurer. When a treasurer or director is elected, he owes a duty, and is answerable, only to the company and its stockholders. A corporation does not owe it to its creditors to exact any amount or degree of service from a director or officer. If the corporation, its directors and stockholders are willing—as they were in the case at bar—that the treasurer yield the practical work of his office to an assistant of their selection, creditors are in no legal position to complain. It is neither a fraud upon them, nor upon stockholders, nor upon the law.

A majority of the Court of Appeals lay some stress upon the fact that the name of the former treasurer was upon the stationery used after the change. In other words, Fargo & Co. continued to use up the stationery then on hand. There is no evidence that this was done to mislead creditors, or that the Rubber Companies knew or approved of it. It may be equally charged to inadvertence, and be disregarded upon the principle that when an act is equally consistent with an honest and dishonest motive, an honest motive is to be presumed. At

best it is but an evidentiary fact of small weight, and was doubtless given its proper proportion in connection with the other evidentiary facts by the master and the trial judge who confirmed his report.

To sum up this phase of the case, a transfer by a debtor to his creditor is not constructively fraudulent unless it is so "plainly inconsistent with an honest purpose" that the law will conclusively presume a fraudulent intent, and will not allow proof to the contrary. (*Huntley* v. *Kingman*, *supra.*) But of the preferential transaction here in controversy Justice BROWN says:

"The evidence satisfies me that there was a *bona fide* attempt to assist the Fargo Company in continuing its business with the hope of ultimately pulling it through, and that if this attempt had been successful it would have redounded greatly to the interest of the general creditors."

He might have gone farther and said that the transaction did in fact benefit the creditors as a whole by reducing the aggregate of their indebtedness.

How can a transaction which might redound, or did in fact redound, to the interest of complaining creditors be "plainly inconsistent with an honest purpose" towards those creditors?

THE PREFERENCE TO THE METROPOLITAN BANK WAS NOT CONSTRUCTIVELY FRAUDULENT.

The facts found by the Master in this branch of the case have already been set out *in extenso* and (except in the particulars above indicated) are apparently not questioned by any of the judges below. It thus appears that this bank was a stranger to the preferential arrangement in January. It was, however, Fargo & Co.'s banker, and

about the 3rd of the following August Fargo & Co. was indebted to it in the sum of $40,000 for money loaned. No person connected with the bank was in any way connected with Fargo & Co. Hence under the Illinois law Fargo & Co., although its failure was then in the contemplation of both parties, could lawfully have preferred this bank by a judgment note for this $40,000.

But on that day C. E. Fargo, its president, applied to this bank for an additional loan of $10,000, representing that Fargo & Co. was indebted to him and his brothers for more than that sum, which they had borrowed for the use and benefit of their company from a Michigan bank upon their individual notes with bank stock belonging to them individually as collateral, and that the company had received and used this money in its business. He then proposed to the bank that, if it would loan Fargo & Co. $10,000 in addition to its then existing loan, so that it could repay him and his brothers, and thus enable them to take up their notes to the Michigan bank, Fargo & Co. would give the Metropolitan Bank two judgment notes for $25,000 each to cover its entire loan. This the bank assented to, loaned the $10,000 (which was deposited to the company's credit), and received two judgment notes, in payment of one of which the bank immediately accepted a conveyance of the equity in the Dixon factory (which afterwards proved worthless), and the other note is the one upon which judgment was entered in favor of the bank, as stated at the outset.

No attempt was made by respondents, upon whom was the burden of proof, to prove that the facts thus stated by Mr. Fargo to the bank were not true, or that the bank's president did not believe them, or had any reason for not doing so. We are, therefore, in judging the bank's con-

duct, to assume that these representations were true in fact, and were relied on by it in making the loan.

The lower courts held these judgment notes constructively fraudulent *in toto*, the Court of Appeals basing its decision in part upon *Sutton Mfg. Co.* v. *Hutchinson*, 23 U S. App., 145, which condemns preferences by a corporation to its directors on the eve of its failure, and also upon the ground that the bank had entered into an "entangling alliance" with the Rubber Companies.

First. Do these judgment notes to the bank violate the rule against preferences to directors? If so, it must be because of the $10,000 transaction, as Fargo & Co. could unquestionably at that time have given preferences for the $40,000 previously due the bank.

Judge Grosscup, in his opinion, says:

"Under these circumstances, I see no reason why the Metropolitan Bank had not a right to advance the $10,000 additional money."

Becoming lawfully a creditor, why could it not take a preference for this additional loan?

The fact that the Fargos were personally liable on the notes and had pledged their individual stock as collateral thereto only put them in a position akin to that of endorsers. But this relation did not incapacitate Fargo & Co. from giving the preference. (See cases cited above and also *Sanford Tool Company* v. *Howe*, *supra*.)

One may lawfully loan money to a corporation on the eve of its failure, and take a preferential security therefor, if it is done in good faith and with honest intent. This bank could lawfully have loaned Fargo & Co. $10,000 at the time it did, and have taken contemporaneously a judgment note therefor, although it then knew that Fargo & Co. were about to fail, provided that it did so in good

faith, and in the reasonable belief that the money was to be lawfully used. If, for instance, Fargo & Co., in anticipation of its failure, had borrowed this money from the bank to pay off its employes, a judgment note given therefor would be upheld. So, if the notes held by the Michigan bank had been those of the Fargo Company, the latter could lawfully have given the Metropolitan Bank, on the eve of its failure, a judgmeut note for money then borrowed to pay the Michigan bank. The preferences to the Metropolitan Bank, under the circumstances here supposed, would be but a substitution of one creditor for another, either of whom could be lawfully preferred upon the eve of failure.

This would be equally true in the cases supposed, although the Fargo Company, after getting the money, dishonestly applied it to other and improper purposes. In each case the test should be whether the money was loaned by the bank in good faith and a reasonable belief on its part that it was to be properly applied. If so, the lender cannot be held guilty of either actual or constructive fraud.

Is the case then changed because the notes held by the Michigan bank were the notes of the individual Fargos? The debt in form is that of the individuals. But the money for which the notes were given having been borrowed for, and used in the business of, the company, is not the company in reality and in a court of equity to be regarded, especially on the question of fraud, *as the real debtor* to the Michigan bank?

That it is to be so regarded is shown by

Poole v. *West Point Association*, 30 Fed. Rep., 513,

This association was a Nebraska corporation and one Brown was its president. The Middleton bank had advanced moneys directly to the corporation, and also advanced moneys to Brown, *who had expended the same for the benefit of the corporation.* These last advances the stockholders of the corporation had attempted to secure by pledging their shares of stock with the bank. The receiver of said Middleton Bank sought in equity to recover the moneys advanced to Brown as a debt of the corporation. It was held that he could do so.

Mr. Justice BREWER (page 518), said:

"I notice, second, the claim of the cross-complainant, the receiver of the Middleton Bank. His claim arises for moneys advanced by the bank directly to the association, and also for moneys advanced by it to Brown, which were by him expended for the benefit of the association, and which were recognized by the association informally as debts of the association, and which were attempted to be secured by an assignment to the bank by each stockholder personally of his shares. *I think equity will jump all intermediate transactions, and treat both amounts as debts from the association to the cross-complainant.*"

In *West* v. *Hanson Produce Co.*, 6 Col. App., 467, money was borrowed for an insolvent corporation, but the bank would not take the company's note for it and the three directors gave their notes direct to the bank for its payment. The Court of Appeals upheld the preference by the company of this debt, and, while disapproving the rule prohibiting preferences to directors, held the question was not involved *because the debt was that of the company.*

Fundamentally considered then, the Metropolitan Bank in August but loaned the Fargo Company $10,000 with which to pay its own debt to the Michigan bank.

Certainly under these circumstances the right to give a preference for this $10,000 is as undoubted as is the right to give a preference for the $40,000 previously loaned.

If this were otherwise it should not avoid *in toto* the bank's preference. To the extent of $40,000 the right to prefer did exist and ought to be upheld.

A different rule might arise if the $10,000 transaction showed actual fraud on the part of the bank. But it does not. It shows at the worst only concurrence in a preference for a *bona fide* debt, and this is not actual fraud, if fraud at all.

We do not here overlook *Atwood* v. *American Exchange Bank*, 152 Ill., 605, which differs from the case at bar in that there the creditor taking a preferential judgment was a stockholder, and as such was held to have been wanting in the candor and good faith required of stockholders in that he permitted the use of his name as a cover to obtain for the directors an unlawful preference. The judgment in that case included a debt due the directors. It seems to have been regarded as a case of actual fraud.

Second. Does the so-called "entangling alliance" between the bank and the Rubber Companies invalidate the otherwise valid preferences of either?

What is said to have this effect is the agreement entered into by these petitioners on the 6th of August, and set out on page 385 of the record. It recites that the parties are large creditors of Fargo & Co., that the bank is about to accept a conveyance of the factory in part satisfaction of its debt, that the Rubber Companies are about to receive an assignment of accounts as security for their claims, and that the parties are about to enter up

judgments upon their claims and that they are to "unite their efforts to collect their respective claims against said company and share *pro rata* in the results thereof."

The *purpose* of this arrangement is both apparent and legitimate. Each of the parties had judgment notes deemed valid preferences. Each was about to reduce the same to judgment and execution, the Rubber Companies in the federal court, and the bank (by necessity) in the state court. This agreement not only reduced legal expenses, but avoided a race between the parties for priority in liens.

All that they agreed to do was to unite their efforts to collect their claims; or, in other words, to assist each other, so far, and only so far, as could legally be done, the law presuming they only intended what was legal.

Doubtless they contemplated a legal assertion of their preferences, if questioned; but it is not a fraud for a creditor to assert, or maintain in court, the validity of a preferential judgment note in fact invalid. No penalty or punishment is incurred by the unsuccessful assertion of a preference. (See cases cited under point III.) If this is true of one party, it is equally so where two unite in the assertion of preferences. The purpose of this agreement was lawful. It is consistent with the good faith which the master finds.

The legal *result* of this agrement was a partial assignment of its preference by each of the parties to the other. If the preference of either, considered by itself, was not illegal, it did not become so because in part assigned to the other. The validity of each preference depends upon its own facts, and these are not

changed by a partial assignment thereof. If either preference is avoided the assignee thereof loses to the extent of his interest therein and no more. He stands in his assignor's shoes, and the consequence to him of relying upon the preference would be the same as to his assignor.

But the position of a majority of the Court of Appeals seems to be that a valid preference, to the extent that it is transferred by partial assignment, loses its validity because the assignee is also asserting another independent preference against the same debtor, which is illegal, and that a legal preference is also invalidated because the preferred creditor takes an assignment of another independent preference which is illegal. This imposes a penalty upon the mere assertion of the preference when assigned that does not exist when not. Valid preferences thus lose their validity when assigned to some persons, but retain it when assigned to others. The assignability of valid claims is thus impaired by reducing the number of persons that may become assignees.

To support these propositions no authorities are cited and we find none. They are applied to the case at bar, although the Master has found that the Metropolitan Bank in no way participated in, or had knowledge of, the facts which are relied on to make the Rubber Companies' preferences illegal, nor did the Rubber Companies participate in, or have knowledge of, the features of the $10,000 transaction which are thought to make the bank's preference fraudulent.

The real objection which the majority of the Court of Appeals expresses to this "entangling alliance" is that, if it be given effect, the Rubber Com-

panies would get *something* as assignees of the bank's preference, whereas the court wants them to get *nothing*. But is not this imposing punishment rather than deciding legal rights, and imposing punishment too upon parties who throughout the transaction have acted in good faith and without intentional fraud?

It is therefore claimed that neither by reason of this "alliance" between petitioners nor other circumstances shown were the preferences to the petitioners constructively fraudulent.

III.

THE RIGHT TO PRO-RATE.

Assuming the preferences to be fraudulent, the question remains whether petitioners are entitled to share *pro rata* with the other creditors.

We understand all the judges below to concede that in taking their preferences they "had no conscious purpose to harm either present or future creditors." Hence the question here is whether a creditor, attempting to take a preference at the time when, and in a state where, preferences were lawful, *with no conscious purpose to harm either present or future creditors*, should be denied the right to share *pro rata* in the insolvent estate, because the particular preference he takes is adjudged contrary to law.

The majority of the Court of Appeals decided this in the affirmative. Mr. Justice BROWN and Judge GROSSCUP held the contrary, Mr. Justice BROWN saying (Rec., 736):

"Upon the whole it does not seem to me that such a case of fraud is made out as authorizes the court to post-

pone the claims of the preferred creditors to those of the general creditors and thereby to practically confiscate them; and that there is no sound reason for departing from the general rule laid down by the Supreme Court in *White* v. *Cotzhausen*, 129 U. S., 329; and *Streeter* v. *Jefferson County Bank*, 147 U. S., 36, wherein the preferred creditors were permitted, after their security had been set aside, to stand upon an equality with the general creditors."

Judge GROSSCUP said (Rec., 636 b):

"This [the question of pro rating] is wholly a matter of conscience: the application of justice to the special matter in hand. It cannot be helped much by what other courts have done under other circumstances. * * * It [the particular method of preference here resorted to] was in a certain sense a new attempt; it was in the line of efforts of creditors to secure themselves; it was, on the whole, not ungenerous to Fargo & Co., and did not, considering their rights to have taken judgment notes, and the fact that none of the other creditors attempted to obtain such notes or any other preference before the general crash, do any actual injury to the other creditors. On the whole, I think the interests of justice will be best subserved by placing them in the class with the other creditors and compelling them to pay the general costs of this litigation."

Judge WOODS, in giving his reasons why the bank should not be allowed to share, says:

"Moreover, the bank, if permitted to share in the fund to be distributed, the Rubber Companies being excluded, would receive in proportion more than if the preferences had been upheld and the division were made between it and the Rubber Companies."

In addition to the decisions of this court cited by Mr. Justice Brown, are the following authorities:

In *Brown* v. *Morristown Stove Company*, 42 S. W., 161 (Tenn., 1897), where the court set aside as an illegal preference a sale by a corporation to its treasurer of its assets in payment of its debt to him, the court said:

"We do not think the position taken by the general creditors under this writ of error, that Holston [the preferred creditor] is not entitled to participate as a creditor in the distribution of the assets of the corporation, is well taken. Resistance to the evidence of the sale to him on the ground of its illegality does not debar him as a creditor or destroy his debt. * * * The effect of avoiding a sale in a case of this kind is, as we understand the law, to place the property of the corporation, as a trust fund, under the control of the court for equal distribution among all its creditors."

See, also, to like effect,

Comer v. *Tabler*, 44 Fed., 467.
In re Reed, 3 Fed. Rep., 798.
In re Cadwell, 17 Fed. Rep., 693.
Phelps v. *Curts*, 80 Ill., 109.
Lobstein v. *Lehn*, 120 Ill., 549.
Riggs v. *Murray*, 2 John. Ch., 565.

Let us apply first the principle of these cases to the Rubber Companies. They have only made an unsuccessful attempt to secure preferenees. Their *motive* in seeking a preference is, in Illinois, recognized as legitimate. If unsuccessful, it is not because they have sought what the law inhibits, but because, under legal advice and without intention to wrong the other creditors they have adopted a *method* which the law will not sanction.

If, as intimated in *Clements* v. *Moore*, 6 Wall., 312, and by Judge Grosscup, each case is to be decided—not by an inflexible rule—but according to its own circumstances, upon what ground can the Rubber Companies be fairly denied the right to pro rate? A corporation, of which they were the largest creditors became embarrassed and its officers desired to overcome—as they had a right to attempt to do (*Sanford Tool Company* v. *Howe*, 157

U. S., 312)—difficulties which they regarded as but temporary. The Rubber Companies were willing to aid by advancing $50,000, if the Fargo Company would—as it lawfully might (*Sanford Tool Company* case, *supra*)—secure their existing debts, and an arrangement was concluded under which the Fargo Company procured $50,000 of new money to be "used in reduction of its general indebtedness as it matured" (Master's report, p. 161), and was thus enabled for seven months to continue its struggle for business life.

Had the January arrangement fulfilled the expectations which the master finds were entertained by the parties to it, all creditors would have been paid in full, and the respondents would have profited by it as much as the petitioners. Though it failed, it resulted in no real injury to the general creditors. While counsel say much about the injustice resulting from such creditors being "drawn in" to give credit, the master reports and the uncontradicted evidence shows that, taken as a whole, they were not "drawn in," but "paid out," by that arrangement to the extent of some $67,000, while the debts due the Rubber Companies were reduced but a few thousand dollars.

In January the Rubber Companies could lawfully have taken preferential judgment notes to be immediately entered. Hence the general creditors, considered collectively, were better off under this arrangement than they would have been, if in lieu thereof a cessation of business followed by these preferences had then taken place.

As to the Metropolitan Bank. The case of this bank need not be here further discussed. As already shown, its conduct, conceding all that can be claimed, amounts only to its concurrence in an unsuccessful attempt by the

Fargos to obtain from their company, on the eve of its failure, a preferential payment of a debt honestly due by it to them. But an unsuccessful attempt, even of a director, to secure a preference from his company, should not work a forfeiture of his debt. (*Brown* v. *Morristown Stove Company*, *supra*.)

Hence, the majority of the Circuit Court of Appeals erred in holding that petitioners were not entitled to share *pari passu* with the other creditors.

The judgment of the Circuit Court of Appeals and the decree of the Circuit Court should be reversed and the bill dismissed for want of equity, and the petitioners should recover their costs in all the courts. These should include the costs and expenses of the receivership. Such reversal would in effect decide that the receiver was improperly appointed. All the facts now before this court were disclosed upon the application for the receiver by petitioners' answers. They contested his appointment to their utmost. Under these circumstances their property ought not to be diminished by charging against it the costs of an improper receivership for which respondents are responsible. *Highley* v. *Deane*, 168 Ill., 266; *McAnrow* v. *Martin*, 183 Ill., 467.

Respectfully submitted.

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